Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

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Niamh Harmon
Committee on Public Petitions
Leinster House
Kildare Street
Dublin 2

Dear Ms Harmon,

Re: Petition No P00047/17

I have been requested to respond on behalf of the Governor to your recent correspondence concerning Petition No P00047/17. I deal in turn below with the issues raised by the petition, firstly describing the statutory role and responsibilities of the Central Bank of Ireland, then turning to our authorised capital and surplus income, before proceeding to the money supply and reserve requirements of the Euro area which are a standard monetary policy tool in central banking, and finishing by outlining the importance of Central Bank independence.

## 1. Statutory role and responsibilities of the Central Bank of Ireland

The Central Bank of Ireland is a statutory body established by the Central Bank Act 1942. The Bank's mission - to safeguard stability and protect consumers – is derived from legislation enacted by the Oireachtas, subject to the relevant EU Treaties.[1]

In accordance with the legislation and in keeping with our mandate, which calls on us to contribute to the public well-being by performing our statutory responsibilities, the Central Bank places a premium on accountability.

By law, the Central Bank is required to prepare an annual report on its activities and an annual performance statement on its financial regulatory activities and present both to the Minister for Finance, prior to them being laid before the Oireachtas. The Central Bank also voluntarily publishes a wide range of information in the form of key reports, strategies, policies and data, including the minutes of Central Bank Commission meetings, and those of the Macroprudential Measures Committee. Representatives of the Bank appear regularly before Oireachtas committees to report on our work, and have a range of communications channels by which we seek to convey information to

[1] The principal statutes governing the Bank are: the Central Bank Acts 1942-2014, the Coinage Act 1950, the Decimal Currency Acts 1969–1990, and the Economic and Monetary Union Act 1998. The Central Bank of Ireland (Surplus Income) Regulations, 1943 provide for the calculation of the Bank's surplus income for each year which, in accordance with section 32H of the Central Bank Act, 1942, is paid into the Exchequer. The Bank is also subject to the Treaty on European Union and the Treaty on the Functioning of the European Union (TFEU), incorporating the Statute of the ESCB and of the ECB, and to any EU laws made under those Treaties that apply to the national central banks of the ESCB.

stakeholders. This includes the Central Bank's Public Contacts Unit, which in 2016 responded to more than 9,200 direct contacts from members of the public. In addition, in keeping with our commitment to transparency, we meet fully our obligations under the Freedom of Information Act.

## 2. Authorised capital and surplus income of the Central Bank of Ireland

The Central Bank is established as a body corporate and the sole shareholder of the Bank is the Minister for Finance. The authorised capital of the Bank is fixed under Section 9(1) of the Central Bank Act, 1942 (as amended) at €50,790. Issued and paid-up capital is €30,474, all of which is held by the Minister for Finance. The Bank returns its surplus income to the Exchequer. As per our latest annual report, the Bank's surplus income amounted to €1,836.2 million in 2016 (2015: €1,795.2 million), which was payable to the Exchequer[2], and represented 80% of the Bank's profits for the year. The amount retained is appropriated to reserves of the Bank and is subject to the approval of the Central Bank Commission each year.

## 3. European System of Central Banks (ESCB)

### a. Money supply in the euro area

Modern economies, including the euro area, are based on fiat money. This is money that is declared legal tender and issued by a central bank but cannot be converted into, for example, a fixed weight of gold. It has no intrinsic value, yet is still accepted in exchange for goods and services because people trust the central bank to keep the value of money stable over time. For this reason, the primary objective of the European System of Central Banks (the ESCB)[3] is to maintain price stability. This is the best contribution monetary policy can make to economic growth and job creation in the euro area.

The European Central Bank (ECB) has adopted a specific strategy to ensure the successful conduct of monetary policy. In the pursuit of price stability, the ECB aims at maintaining inflation rates below, but close to, 2% over the medium term. The strategy includes an analytical framework for the assessment of all relevant information and analysis needed to take monetary policy decisions. This framework is based on two pillars: economic analysis and monetary analysis.

The ECB acts as a bank for the commercial banks and this is also how it influences the flow of money and credit in the economy to achieve stable prices. Commercial banks, in turn, can borrow money from the ECB. This is known as "base money" or "central bank money". In normal times, the ECB's main tool for controlling the quantity of "central bank" money is setting very short-term interest rates – the "cost of money". These rates serve as a point of reference for other interest rates in the economy: high rates usually correspond to reduced demand for loans, while low rates may encourage businesses and households to borrow more.

Commercial banks can also create money themselves, often referred to as "deposit money", i.e. bank deposits – this happens every time they issue a new loan. Specifically, commercial banks take in a

[2] The Bank complies with Statutory Instrument 93/1943 – *Central Bank of Ireland (Surplus Income) Regulations*, 1943. The Bank may retain up to a maximum of 20 per cent of profit in each year.

[3] The term ESCB refers to the ECB and the national central banks of the EU Member States. The term Eurosystem refers to the ECB and the national central banks of those Member States whose currency is the euro.

deposit from a saver, and then issue a loan with a value that is a fraction of the deposit to a borrower. This loan in turn typically becomes another deposit by the borrower in the banking system. When commercial banks make a loan, they act as a financial intermediary between savers and borrowers; while doing so they monitor the behavior of the borrower so that they can assess risks. Through this process of financial intermediation, deposit money is therefore created, and rests on top of base money. The difference between "central bank" and "deposit" money is that the former is an asset for the economy as a whole, but it is nobody's liability. Deposit money, on the other hand, is named this way because it is backed by private credit: if all the claims held by banks on private debtors were to be settled, the deposit money created would be reversed to zero. So it is one form of money that is created and can be reversed within the private economy.

When the room to cut those short-term interest rates directly controlled by the ECB is limited, the ECB can influence money supply through purchasing assets in the financial market. The seller can then use the additional liquidity to buy other assets or, in case of a commercial bank, extend credit to the real economy.

### b. System of minimum reserves in the euro area

The ECB requires credit institutions to hold minimum reserves on accounts with the national central banks of the Eurosystem (the NCBs) within the framework of the Eurosystem's minimum reserve system. Credit institutions located in Ireland are therefore required to hold these minimum reserves with the Central Bank of Ireland. The legal framework for this system is laid down in Article 19 of the ESCB Statute, Council Regulation (EC) No 2531/98 and Regulation (EC) No 1745/2003 of the ECB (ECB/2003/9). The application of Regulation ECB/2003/9 ensures that the terms and conditions of the Eurosystem's minimum reserve system are uniform throughout the euro area.

The Eurosystem's minimum reserve system primarily pursues the monetary functions of: (i) the stabilisation of money market interest rates; and (ii) the creation or enlargement of a structural liquidity shortage.

In the application of minimum reserves, the ECB is bound to act in pursuance of the objectives of the Eurosystem as defined in Article 127 of the Treaty on the Functioning of the European Union (the TFEU) and Article 2 of the Statute of the ESCB and of the ECB (the ESCB Statute), which implies, *inter alia*, the principle of not inducing significant undesirable delocation or disintermediation.

## 4. Central bank independence

In recent years, there has been an international trend to confer greater independence on central banks. Almost all central banks in OECD countries are operationally instrument-independent, counting on their own tools to set or target several interest rates. Independence has been granted to central banks in order to shield them from short-term political influence when fulfilling their mandate of ensuring price stability. Extensive empirical evidence and theoretical analyses have shown that independent central banks are better capable of maintaining low inflation rates.

An independent central bank is also likely to have more credibility. If people have more confidence in the central bank, this helps to reduce inflationary expectations. In turn, this makes inflation easier to keep low.

Article 130 of the Treaty on the Functioning of the European Union (TFEU) (and, in similar terms, Article 7 of the ESCB Statute) provides for the independence of NCBs when performing ESCB tasks.

The scope of central bank independence protected by the TFEU extends to functional independence, institutional independence, personal independence and financial independence, as further elaborated in the ECB Convergence Reports.[4] The Central Bank Act 1942 reflects the independence of the Central Bank of Ireland assured by EU law. For example, Section 6(1A) provides that nothing in the Irish Central Bank Acts 'affects the independence of the Bank, the Governor and the Commission required by the [TFEU] and the ESCB Statute'. Section 6(1B) further provides that nothing in the Central Bank Acts authorises any person or authority to give any direction to, or require any action by, the Bank, the Governor or the Commission if compliance with same would be inconsistent with the TFEU or the ESCB Statute.

I trust the above information will be of assistance to the Committee. If you require any further information, please do not hesitate to contact me.

Yours sincerely,

[4] The most recent Convergence Report was published in June 2016 and is available on the ECB website.